

7 September 2022

www.water.org.uk

Introduction

1. Water UK is the representative body and policy organisation for water and wastewater service providers across the UK. We welcome the opportunity to respond to Ofwat's consultation on the methodology for PR24¹ on behalf of our members. This response represents the considered and consolidated views of Water UK's members. It does not seek to cover all aspects of the consultation, in particular the more technical aspects; companies will address these in their individual responses.

Summary

2. The challenges facing the sector as we work towards PR24 are arguably greater than any we have previously faced, with pressing long-term challenges such as ensuring resilience to climate change and population growth, delivering net zero and ensuring a sustainable approach to asset health, and customer and stakeholder expectations of rapid environmental improvement, in particular on pollution and river health – all within the context of a cost-of-living crisis, the current high levels of inflation and the economy entering recession.
3. In this context, we support the intentions in the draft methodology of:
 - focusing on the long term;
 - ensuring a level-playing field between different ways of delivering outcomes;
 - delivering greater environmental improvements; and
 - moving faster towards net zero.
4. These objectives are consistent with those we set out recently in the Water 2050 White Paper², which proposed reforms to enable more environmental impact more rapidly and efficiently and to protect long-term customer interests through enabling the right investments to be made at the right time.

¹ <https://www.ofwat.gov.uk/consultation/creating-tomorrow-together-consulting-on-our-methodology-for-pr24/>

² <https://www.water.org.uk/water2050/>

5. It is not clear however that the draft methodology makes sufficiently decisive moves to evolve the regulatory framework in these areas to be confident that the long-term challenges facing the sector can be met. We see potential for some elements of the draft methodology to be developed further to the benefit of customers and the environment and expand on this below.
6. We also set out below areas where we have serious concerns with the draft methodology, including the lack of weight attached to the findings of longest and most considered set of water price review Redeterminations ever undertaken, and where there are significant gaps that need to be addressed.
7. The industry looks forward to working closely with Ofwat and other stakeholders so that the final methodology for PR24 provides a firm foundation for the sector to rise to meet the significant challenges it faces.

Areas where the final methodology could be bolder

8. We are encouraged that in the draft methodology Ofwat recognises that there is not currently a level regulatory playing field between nature-based schemes and more traditional approaches and that this has unintended consequences, and is considering how this could be addressed.
9. We urge Ofwat to go further in two ways – firstly, by adapting the methodology to ensure a level playing field, and secondly, by confirming that this adaptation would also apply to catchment and partnership-based approaches, which have similar cost and risk profiles to nature-based schemes. Implementing an approach along these lines would enable greater environmental value to be delivered, more sustainably.
10. We also note that it is the interplay between economic and environmental regulation that will determine whether the Government's wish³ for a significant increase in the use of nature and catchment-based solutions is realised. For the widest benefits to the environment to be realised without putting unacceptable levels of pressure on customer bills, there is also a need for a change in the way that the Environment Agency approaches these issues. This could be achieved by adopting the principles of 'Outcome Based Environmental Regulation'.⁴
11. We also encourage Ofwat to go further to ensure a sustainable, forward-looking and long-term approach to asset health. We have recently published analysis⁵ demonstrating that the sector's rate of asset replacement is well below that of its European peers. There is a need for a step-change in the level of asset maintenance and replacement at PR24 to ensure that the sector is on a long-term sustainable path – and the importance of taking a forward-looking approach to assessing needs at

³ <https://www.gov.uk/government/publications/strategic-policy-statement-to-ofwat-incorporating-social-and-environmental-guidance/february-2022-the-governments-strategic-priorities-for-ofwat>

⁴ See <https://www.water.org.uk/water2050/> and <https://www.wessexwater.co.uk/corporate/strategy-and-reports/performance/ober-report>

⁵ <https://www.water.org.uk/publication/options-for-a-sustainable-approach-to-asset-maintenance-and-replacement/>

price reviews is all the greater given that climate change means that assets are being placed under greater pressure than in the past.

12. The analysis proposed how a step-change could be achieved through a combination of Price Control Deliverables related to specific projects and a dedicated totex allowance, with specific totex under/outperformance sharing rates for asset maintenance and replacement, to drive a step change across the industry. We urge Ofwat to give serious consideration to these proposals for PR24, rather than deferring action to future price reviews and risk storing up problems for the future.

Areas where further clarity is needed

13. In some important areas there is not yet enough detail to be able to fully assess the methodology, notably on bioresources, the approach to assessing enhancement costs, and how uncertainty in the required scope of enhancements will be managed and mitigated. Clarity on these issues is critical as, if the expectations of the Governments and other stakeholders are to be met, the regulatory regime will need to enable and facilitate a substantial investment programme, with significant uncertainty associated with some elements of it.
14. To take just one example, the Government has recently announced⁶ plans to require upgrades to wastewater treatment work in current 'nutrient neutrality' areas; it would seem likely that similar measures may be introduced in further areas in advance of 2030. Changes like this may require switching to alternative adaptive pathways identified in companies' Long Term Delivery Strategies; in circumstances like this, an in-period switch may be needed, and this should be enabled without the need for an IDoK.
15. More clarity is also needed on the approach to assessing the scope for frontier shift and addressing the impact of real price effects – particularly in the light of the current evidence of the sector having to cope with greater exposure to costs driven by external events beyond companies' control, not just in energy but also in other aspects of the supply chain. It will be important that there is further engagement on all these areas with the industry in advance of the final methodology.
16. We generally welcome Ofwat's high level intention of escalating the sector's ambition towards net zero, supporting and stretching companies. Whilst we broadly welcome the introduction of a package of carbon-focussed requirements, incentives and funding mechanisms at PR24, the draft methodology lacks sufficient detail or clarity to enable companies to effectively develop their price review plans for carbon, or to allow Ofwat to secure and assess consistent and comparable proposals.
17. We would like to work collaboratively with Ofwat (and other stakeholders) through the industry-wide carbon working groups at Water UK and UKWIR to develop the technical details and clarity required to support success at PR24 on carbon.

⁶ <https://www.gov.uk/government/news/government-sets-out-plan-to-reduce-water-pollution>

Areas where the approach in the draft methodology should be revised

18. Overall, those areas where the picture is already clearer signal increasingly asymmetric downside risks, notably the removal of caps, collars and deadbands on individual outcome delivery incentives. This will have the greatest impact on measures which are sensitive to outlier events, such as supply interruptions.
19. Unless Ofwat revises its proposed approach, a significant increase in totex would be needed for investment to reduce the impact of outlier events, and/or an increase to the cost of capital to recognise the increased level of risk. There would also be a risk of unintended consequences of companies diverting totex to those performance commitments with greatest ODI risk – which may not be in line with customer priorities and may lead to expenditure being inefficiently focused on short term solutions.
20. In particular, we are concerned Ofwat’s proposed approach would result in almost all companies being penalised every single year on the key drinking water quality measure CRI, an outcome that would cause unnecessary damage to the sector’s justifiably strong reputation for providing high quality drinking water. We understand that Ofwat’s proposed approach is not supported by the expert regulator for drinking water quality, the DWI. We urge the retention of a deadband for CRI, which could be set at a similar level to PR19.
21. Asymmetric risks are also apparent in the approach to setting performance targets, cost allowances and price control deliverables for investment with long term benefits. We recognise the role of the regulator in scrutinising companies’ plans and seeking to ensure value for money for customers. However, the apparent expectation that endless service and environmental improvements can be delivered without incremental costs for customers cannot be sustainable and is not consistent with the recent water sector Redeterminations⁷, where for example incremental costs of further reducing leakage were recognised.
22. The assertion that the cost of achieving levels of performance can be met from allowed base costs and further assumed efficiency gains creates a significant downward skew to the risks facing all companies.
23. We urge Ofwat to work with the sector to understand more fully what base costs buy before assuming further efficiency gains or further stretch for performance commitment levels for common performance commitments. It is crucial this includes a bottom-up, engineering-based assessment, rather than relying solely on top-down econometric models.
24. If additional costs of achieving further improvements in performance levels are not explicitly recognised, an alternative would be to explicitly recognise the additional efficiency challenge required to absorb the additional costs needed to deliver further improvements.

⁷ https://assets.publishing.service.gov.uk/media/60702370e90e076f5589bb8f/Final_Report_-_web_version_-_CMA.pdf

25. This is also the case for the costs of inflationary pressures on retail services, which given the current high inflation environment are highly material, but the draft methodology proposes to disregard by not indexing retail costs.
26. We also note that the degree of ambition included in performance commitment targets should be based on customer priorities and research, to avoid resources being diverted to deliver incremental improvements in performance commitments which are not the highest priority for customers.
27. The degree of risk that companies are exposed to in the current regulatory period is also higher because the only uncertainty mechanism that exists to share the risks of real price effects is for labour prices. This leaves companies fully exposed to real price effects on energy and other commodities such as steel. The latest forecasts⁸ show that energy costs are contributing to further increases in inflation, with businesses exposed and unprotected by the Ofgem price cap.
28. We believe that the methodology should extend beyond the current uncertainty mechanism for labour to include other real price effects, so that cost impacts beyond CPIH that are not within management control are fairly shared. Asymmetric risks could also be mitigated by redesigning price control deliverables so that they allowed for rewards in certain circumstances and were part of an approach that allowed for easier but not frivolous reopeners.
29. Overall, the approach set out in the draft methodology risks the effective erosion of resilience in the sector to shocks such as those it is seeking to cope with now through the prolonged period of dry weather, and, in some parts of the country, drought.
30. The asymmetric risks associated with the setting of performance targets, costs and incentives and in some instances price control deliverables for investment with long term benefits should be addressed in the final methodology. If this is not done, it will be important to take this into account when considering the appropriate risk/reward balance needed to maintain the investor confidence that underpins the sector's ability to deliver for customers, and to ensure investment can be attracted to deliver the step-change that is needed.
31. Regarding the financing of the sector (chapters 7 and 8 of the consultation), we note that, as in Ofwat's December 2021 consultation on risk and return⁹, little regard is given to the decisions on financing in the recent water sector Redeterminations, and in particular on the approach to the cost of equity.
32. In this response we will not enter the debate on specific parameters for the capital asset pricing model or on the range of cross checks to results from this model, which will be well covered by others. We do however reiterate our disappointment¹⁰ that Ofwat has chosen to reject almost all of the CMA's 2021 decisions, reached after intensive deliberation in what was the longest and most considered set of water price review Redeterminations ever undertaken.

⁸ <https://www.bankofengland.co.uk/monetary-policy-report/2022/august-2022>

⁹ <https://www.ofwat.gov.uk/consultation/pr24-and-beyond-discussion-paper-on-risk-and-return/>

¹⁰ <https://www.water.org.uk/publication/water-uk-response-to-ofwat-discussion-paper-on-risk-and-return/>

33. In particular, Ofwat has chosen to ignore or attach little weight to the evidence which underpinned these Redetermination decisions where they deviated from Ofwat's original position in its Final Determinations. By contrast, where the CMA found in favour of Ofwat's position, this is considered by Ofwat to validate its approach.
34. As we observed previously, we recognise that there have been subsequent appeals against regulatory decisions (as opposed to Redeterminations) in the energy sector and indeed that there may be more appeals in other sectors in the future ahead of PR24, the decisions of which may not be entirely irrelevant to the approach taken at PR24. However, the water sector appeals and their final determinations from less than a year ago remain by far the strongest precedent for Ofwat at PR24, in particular:
- they were made on companies operating within the sector who are facing the specific risks water companies face as opposed to energy networks or air-traffic control which have very different characteristics; and
 - the appeal mechanism in the energy sector, from which Ofwat draws most heavily, is very different as under that mechanism, as the CMA itself has noted, the CMA is simply required to determine whether the regulator has made an 'error' rather than what they consider to be the right or best approach to estimation – which is what the water redetermination process implies.
35. In this context Ofwat should be setting itself a high evidential bar for deviating from the CMA water Redeterminations; the draft methodology does not meet this high bar.
36. Parliament set out a legal framework for water companies and their investors at privatisation that allows companies the opportunity to seek a full 'de novo' redetermination in extreme circumstances. Up until PR19 that framework was rarely triggered, and the regulatory model enjoyed a significant degree of stability and predictability. Where companies do seek a CMA appeal, our view remains that both sides have a responsibility to accept the decisions and the precedent it sets; otherwise, the same issues are returned to the CMA on multiple occasions, damaging confidence in the checks and balances in the regulatory system.
37. We also note the comments in the methodology document that Ofwat may 'set a lower level of notional gearing at PR24 compared to PR19'. We reiterate our view that the economic rationale for adopting a notional structure does not support Ofwat's intention to adjust notional gearing and the level Ofwat is indicating would not represent an efficient water company.
38. It would not be in customers' long-term interests, nor consistent with the evidence, for the notional structure to be changed. The combination of lower notional gearing and expectations of a greater role for equity – but a downside skewed risk-profile as noted above – risks compromising the sector's attractiveness at a point when sustained investment is needed to meet customer and stakeholder expectations.

39. Turning to the process of business plan assessment (chapters 10 and 11 of the consultation), we recognise that business plan incentives are now an established part of the regulatory process. We do however caution that it is important to be confident that these powerful incentives are targeted appropriately in the long-term interests of customers and the environment.
40. In our view, business plan incentives should aim to incentivise each company to produce a well-evidenced plan that best meets the needs of its customers and communities in the round. This may not be aligned with a prescriptive list of centrally produced regulatory assumptions, including Ofwat's 'early view' on a range of key issues, which could deliver a 'lowest cost' plan that may not meet the needs of customers, communities and the environment, nor enable delivery of the Governments' policy priorities.
41. The UK Government's Strategic Policy Statement¹¹ commits to taking a long-term approach to investment, recognising that a system that works in the enduring interests of consumers does not simply mean lower prices in the short-term at the expense of future generations.
42. In this context, it will be important that affordability concerns are addressed through providing targeted support to financially vulnerable consumers, rather than by inappropriately driving down investment to the detriment of long-term resilience and the protection and enhancement of the environment. The current drought vividly underlines the importance of enabling sufficient investment for the sector to plan for and maintain long-term resilience.
43. Penalising companies for departing from regulatory assumptions when they may not be in their own customers' long-term interests would inadvertently entrench short-term thinking that we are all seeking to avoid and would not be in the interests of customers, communities or the environment.

Conclusion

44. In conclusion, we see potential for some elements of the draft methodology to be developed further to the benefit of customers and the environment. There are however areas where we have serious concerns, including the lack of weight attached to the findings of longest and most considered set of water price review Redeterminations ever undertaken, and where there are significant gaps that need to be addressed. The industry looks forward to working closely with Ofwat and other stakeholders so that the final methodology for PR24 provides a firm foundation for the sector to rise to meet the significant challenges it faces.

¹¹ <https://www.gov.uk/government/publications/strategic-policy-statement-to-ofwat-incorporating-social-and-environmental-guidance/february-2022-the-governments-strategic-priorities-for-ofwat>